BEFORE THE BOARD OF OIL, GAS AND MINING
DEPARTMENT OF NATURAL RESOURCES
STATE OF UTAH

IN THE MATTER OF THE REQUEST FOR AGENCY ACTION OF EP ENERGY E&P COMPANY, L.P. FOR AN ORDER POOLING ALL INTEREST, INCLUDING THE COMPULSORY POOLING OF THE INTERESTS OF ARGO ENERGY PARTNERS, LTD., DUSTY SANDERSON, HUNT OIL COMPANY, KKREP, LLC, AND J.P. FURLONG CO., IN THE DRILLING UNIT ESTABLISHED FOR THE PRODUCTION OF OIL, GAS AND ASSOCIATED HYDROCARBONS FROM THE LOWER GREEN RIVER-WASATCH FORMATIONS COMPRISED OF ALL OF SECTION 2, TOWNSHIP 3 SOUTH, RANGE 5 WEST, U.S.M., DUCHESNE COUNTY, UTAH	**REPLY TO SECOND MEMORANDUM** Docket No. 2015-013 Cause No. 139-130

COMES NOW, J.P. Furlong Co., ("Respondent") acting by and through its attorney, Anthony T. Hunter, pursuant to Utah Admin. Code Rule R641-105-300, in conjunction with its concurrently filed Motion for Consideration Out of Time, and respectfully states:

INTRODUCTION

There are two issues before the Board. First, can the Board lawfully impose a nonconsent penalty when the non-operators are not given the opportunity to participate in the drilling of the well prior to its commencement? Second, can a statutory right to participate in a well be made conditioned upon the acceptance of a voluntary contractual obligation?

I. Can the Board lawfully impose a nonconsent penalty when the non-operators are not given the opportunity to participate in the drilling of the well prior to its commencement?

No. "…[T]he terms [a]re imposed by compulsory state action. It is doubtful that a penalty assessment could meet constitutional standards of due process when the penalized party was not

given an opportunity to participate in the drilling."[1] By virtue of the Spacing Orders entered against the captioned lands, the Board determined that every owner of oil and gas under the captioned lands has the legal right to produce his or her fair share of the resource.[2] This is a vested, absolute right, given by the State in exchange for depriving the resource owner of his rights under the rule of capture.[3] Without notice and opportunity to exercise this statutory right in a timely fashion, enforcing a penalty against him impairs that owner's rights to produce the resource without just compensation[4] and without due process of law.[5]

Petitioner's leading argument is that Respondent has failed to consent to bear his proportionate share of *operating* the well,[6] and that this failure alone justifies the imposition of the statutory nonconsent penalty.[7] This argument fails for three reasons.

First, "[t]he risk penalty concept is utilized in order to compensate the risk takers for the chances taken by them in *drilling a dry hole.*"[8] However, Petitioner is correct that there are other risks faced by an operator:

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[1] *In the Matter of SAM Oil, Inc., et al.,* 817 P.2d 299 (Utah 1991) at Footnote 4. It really doesn't matter how different Michigan's statutory scheme is from Utah's. It's a compulsory statute, not a voluntary contract.

[2] "In short, under the Act, it is not possible to ascertain a landowner's correlative rights until the Board acquires the necessary data in a formal hearing, makes findings of fact, and enters a spacing and drilling unit order." *Cowling v. Board of Oil, Gas and Mining*, 830 P.2d 220, 226 (Utah 1991). These rights have been ascertained since the entry of the Order in Cause No. 139-8 on September 20, 1972.

[3] Kramer, Bruce M., *Compulsory Pooling and Unitization: State Options in Dealing with Uncooperative Owners*, 7 J. ENERGY L. & POL'Y 255, 256-258 (1986) ("Kramer," *infra*).

[4] *See* Utah Constitution, Article I, Section 22. *See also* United States Constitution, Amendment V.

[5] *See* Utah Constitution, Article I, Section 7. *See also* United States Constitution, Amendment XIV.

[6] *See* Petitioner's Memorandum in Support of Request for Agency Action and in Reply to J.P. Furlong Co.'s Response to Agency Action, filed April 16, 2015, Pages 4-6 ("Second Memorandum," *infra*).

[7] In an extensive footnote on Page 5, Petitioner notes that by signing an AFE, Respondent has already committed to the riskiest parts of drilling a well, despite the fact that there is no longer a risk of completing a well. In effect, Respondent has ratified all the technical and logistical decisions Petitioner made in order to achieve production in paying quantities. *See* Footnote 7, *infra.*

[8] Kramer at 260 (*emphasis added*). Also, "The [Utah-style statutory scheme] ... allows the non-consentor to be 'carried' during the drilling period, but it imposes upon him a risk penalty to compensate the drilling parties for the risk of *drilling a dry hole.*" *Id.* at 261 and Footnote 35 (*emphasis added*). Also, "In *In re Kohlman*, the South Dakota Supreme Court concluded that the purpose of imposing a risk penalty on non-consenting working interests owners is

> There are at least three types of risks that may be involved in drilling an oil and gas prospect. *The greatest risk is in drilling a dry hole.* A second risk is encountering unexpected mechanical or geological problems which greatly increase the actual cost of drilling. The third type of risk is the risk of drilling a marginally productive well which will never return to the operator his investment in the drilling and operating expenses.[9]

In the hierarchy of risk, the day-to-day operation of a productive well – even a marginally productive well – ranks dead last. In order to justify the imposition of a statutory risk penalty on an owner, there must be a statutorily defined *element* of true risk in the actions of the operator. Indeed, Professor Kramer notes, "[b]y having a laundry list approach in which certain items are recoverable only as to their actual costs while others are subject to a penalty, an intent to limit the operator's recovery to those items truly at risk in the venture is evident."[10] Unfortunately for Petitioner's argument, the Legislature agrees with Professor Kramer's assessment of the relative degrees of risk imposed by those three categories. His top two types of risk – the types covered by the AFE executed by Respondent – are compensated by the Legislature at a rate between 150% and 400%.[11] The third type – the expenses associated with operating the well – are capped at 100% (*i.e.*, riskless).[12] It defies logic to argue that failing to agree in advance to paying for a riskless item somehow justifies the imposition of the risk-compensating nonconsent penalty to the owner.

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to relieve the nondrilling interest owner from having to advance his proportionate share of the drilling costs, but provide extra compensation from production (if oil is found) to the drilling party who had advanced the entire *cost of a dry hole.*" *Id.* at 264.

[9] *Id.* at 266 (*emphasis added*).

[10] *Id.* at 265.

[11] "[A]n amount to be determined by the board but not less than 150% nor greater than 400% of the nonconsenting owner's share of the costs of staking the location, wellsite preparation, rights-of-way, rigging up, drilling, reworking, recompleting, deepening or plugging back, testing, and completing, and the cost of equipment in the well to and including the wellhead connections." Utah Code Ann. § 40-6-6.5 (4)(d)(i)(D).

[12] "100% of the nonconsenting owner's share of the cost of operation of the well commencing with first production and continuing until the consenting owners have recovered all costs…" Utah Code Ann. § 40-6-6.5 (4)(d)(i)(C).

Second, in addition to being illogical, Petitioner's arguments are not supported by the evidence. Petitioner rejected Respondent's suggested terms of operations and filed this action – although not in that order.[13] Respondent has supported Petitioner's request for a pooling order for the captioned section from its first appearance.[14] Such an order, by statute, would require Respondent to pay its proportionate share of the costs of operation.[15] Obviously, Respondent intends to comply with any legally issued order of the Board. Any assertion by Petitioner that Respondent has affirmatively or tacitly refused to participate in operating the Neihart Well is flatly contradicted by the evidence.

Third, the very existence of the nonconsent penalty is predicated on the assumption that the owner actually has the opportunity to agree to drill the well *before* it is drilled. "If the overall purpose of the penalty is to reward the risk taker for bearing someone else's share of a dry or marginally productive well, the leading factor in calculating the penalty must be the likelihood or unlikelihood that oil or gas will be found at the well's *proposed location.*"[16] The likelihood of finding oil or gas at the bottom of the Neihart Well went from some-unquantifiable-percent-greater-than-zero to 100% between August 7, 2014 and October 10, 2014. Any attempt to quantify a risk penalty after drilling has commenced is an exercise in futility – either because the number changes with each foot of progress or because the possibility of the presence of hydrocarbons is finally either confirmed or eliminated.

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[13] *See* RAA filed March 10, 2015 and Petitioner's Exhibit T dated March 17, 2015.
[14] *See* Response to RAA, Prayer for Relief ¶ 1.
[15] "Each pooling order shall provide for the payment of just and reasonable costs incurred in the drilling and operating of the drilling unit, including… reasonable charges for the administration and supervision of operations…" Utah Code Ann. § 40-6-6.5 (4)(a)(i)(B). *See also* Utah Code Ann. § 40-6-6.5 (4)(d)(i)(C), *supra.*
[16] Kramer at 266-67 (*emphasis added*).

II. Can a statutory right to participate in a well be made conditioned upon the acceptance of a voluntary contractual obligation?

No. Petitioner's entire case boils down to this statement: Unless a non-operator agrees to participate in a well on terms acceptable to an operator acting in good faith in its sole discretion before the operator files a pooling request, the Board can find that the non-operator has refused to agree to carry out his statutory responsibilities. A ruling in favor of Petitioner on this question means – unequivocally – that if an owner wants to exercise his statutory right to have the Board decide if a contractual term is just and reasonable, it will cost him 150% to 400% of the value of his interest *unless* he can prove that the term is unfair to owners and operators generally – not on the specific facts of the case.[17] This places an unconscionable burden upon small owners and operators who have 1.) effectively zero input into the drafting of industry standard contracts, and 2.) nowhere near the resources of large operators, and 3.) limited access to the specialized legal and technical expertise needed to effectively analyze these issues at the speed required by a typical Board hearing schedule.

On the first point, Petitioner argues that if the Board finds any fault with any term in its proposed JOA, it would be acting arbitrarily and capriciously, based on its prior findings of *fact*. Petitioner cites Cause No. 139-122 and Cause No. 139-128, two Causes in which there were no respondents or other formal opposition. Therefore, there was nothing on the record to contravene the petitioners' self-serving testimony that the terms of the proposed JOAs were just and reasonable. That is not true in this Cause. Let us assume *arguendo* that a finding of

[17] Petitioner states that the only protections the non-operator has are the "good faith" negotiations of the "just and reasonable" terms offered by the operator. *See* Second Memorandum at Page 8. Then Petitioner argues that the common usage of the JOA form combined with the unique requests of Respondent justifies a *prima facie* finding of good faith negotiation of just and reasonable terms on the part of Petitioner. *Id.* at 10-11. If this is true, the burden to prove that the operator was acting in bad faith and unjustly or unreasonably then shifts to the Respondent. How exactly can this be deemed adequate protection for the non-operator?

"justness and reasonableness" in a form contract of adhesion (like the "conditional" Form 610 proposed by Petitioner) is subject to the less restrictive judicial scrutiny suggested by Petitioner. Because mixed findings of fact and law "must be rationally based and are set aside only if they are imposed arbitrarily and capriciously or are beyond the tolerable limits of reason,"[18] a different factual record in a contested hearing would logically justify a different view of the "standard" Form 610. Indeed, in order to support a finding that Petitioner's proposed JOA is just and reasonable, the Board's eventual findings of fact will have to show that it "balance[d] the competing interests of affected parties..."[19] On the other hand, if the Board were to conclude that the unmodified Form 610-1989 JOA was just and reasonable as a matter of *law* (*i.e.*, binding or persuasive precedent that applies in every case before it, as Petitioner seems to encourage), it might constitute reversible error on appeal.[20]

On the third point, Petitioner's allegation that Respondent somehow has knowledge allowing it to make a "more informed decision"[21] about the Neihart Well borders on ludicrous. The Neihart Well has been designated confidential pursuant to Utah Admin. Code Rule R649-2-11 and therefore no data is publicly available.[22] The Petitioner has sent no well data, production tests, or any other pertinent insider information to Respondent that the Respondent could locate. The only material fact known to Respondent – or indeed, to any other party Petitioner wishes to impose the nonconsent penalty upon – is that the Petitioner believes the Neihart Well is capable

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[18] *Utah Chapter of Sierra Club v. Board of Oil, Gas, and Mining*, 289 P.3d 558, 565 (Utah 2012).
[19] *Harken Southwest Corp. v. Board of Oil, Gas and Mining*, 920 P.2d 1176, 1179 (Utah 1996).
[20] "In its conclusions of law, the Board found that "as a rule," a party who joins a unit subsequent to the commencement of a well would be subject to a nonconsent penalty. The Board cites no authority on this point, and we are not aware of any. We therefore think the Board's statement that this is a general rule is too broad." *In the Matter of SAM Oil, Inc., et al., supra* at 304.
[21] *See* Second Memorandum at 18.
[22] "Information that shall be held confidential includes well logs, electrical or radioactivity logs, electromagnetic, electrical, or magnetic surveys, core descriptions and analysis, maps, other geological, geophysical, and engineering information, and well completion reports that contain such information." Utah Admin. Code Rule R649-2-11 (4).

of production in paying quantities. Of course, this fact was made known to them once they received their "conditional" election letters from Petitioner. If there was no chance of recovering drilling costs from production, there would be no need to pool these interests in the first place.

Further on the third point, and contrary to the dire warnings[23] of the Petitioner, not one of the parties that Petitioner wishes to recover a nonconsent penalty against in this case is "riding down" the well. This is simply because none of these parties knew there was a well to ride until it was already drilled – and in Respondent's case, already completed.[24] Even the sharpest oil and gas lawyer can't advise a client on the best way to leverage a holdout scenario when the operator has already drilled the well.[25] One cannot win a game one does not even know he is playing.[26]

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[23] Second Memorandum at Page 16.

[24] Petitioner relies on the *SAM Oil* case for the proposition that the nonconsent penalty "is designed to ensure that nonparticipating owners do not benefit from the successful outcomes of risks they do not take." *In the Matter of SAM Oil* at 302, *supra at* Footnote 1. In that case, the Utah Supreme Court was interpreting a voluntary contract (*Id.* at 301) governing a Federal Exploratory Unit (*Id.* at 300-01) that the non-operator asked to join (Id. at 303) after the subject well was completed. The *SAM Oil* case is instructive for its contrasts to this case, not its similarities.

[25] Petitioner's "daisy chaining" argument would be more persuasive if the chain originated prior to the spud date.

[26] On the other hand, this case is illustrative of the types of games operators can play. "Certainly without any assertion or implication that [Petitioner] acted in such a manner (*See* Second Memorandum at Page 16)," consider the following chronology:

- Operator X discovers that mineral ownership of a mere 2 acres of a 640-acre drilling unit (0.3125%) is complex and uncertain, and owners are either not locatable or not receptive to an initial offer of protection leases to ensure that all possible ownership scenarios are covered.
- The proportionate share of the costs borne by those owners on a $1,000,000 well would be $3,125.
- Proper determination of the owners costs $10,000 in title examination fees (an additional 1% cost).
- Operator X drills the well, but notifies no one on the 2-acre tract of their statutory right to lease or participate.
- Operator X believes the well to be productive in paying quantities, but first production is not yet reported.
- Notices are sent and are either elicit no response (not locatable) or are given an offer conditioned on accepting Operator X's terms under threat of forced pooling.
- Confused and intimidated, the owners become uncommunicative, hoping the problem "goes away." (cont'd)

The only way to prevent "gaming" the system is for everyone to be given the opportunity to declare themselves "in" or "out" prior to drilling the well. If, on the other hand, the operator chooses to drill before giving the other owners the opportunity to make that decision, he is free to do so. But he has effectively waived his right to pursue the statutory nonconsent penalty.

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CONCLUSION

Respondent asserts that it has already agreed to shoulder its fair share of the costs of drilling, completing and operating the well – just not on the terms Petitioner prefers, and despite the fact that it never had an opportunity to take a risk on drilling. This cannot be sufficient cause to justify the imposition of the statutory nonconsent penalty. This reasoning places every single non-operator in Utah at the mercy of the first person to file an APD in a drilling unit.

Respectfully Submitted this 17th day of April, 2015.

By: _____

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- (cont'd) Upon their default, and once a 400% penalty is authorized, rather than being able to recover $3,125 from the "nonconsenting" owners, Operator X can recover $12,500 from the proceeds of production.

- Operator X realizes a $2,500 profit by delaying sending notices until after the well is drilled. And don't forget that it never paid a dime in bonuses or rentals, either.

CERTIFICATE OF MAILING

I certify that I caused a true and correct copy of the foregoing document to be mailed via U.S. Postal Service and via electronic mail to the below named parties.

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Signed, this 17th day of April, 2015.